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PASS: CEA, TREAS, FRB

E.O. 11652: N/A
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SUBJECT: ECONOMIC AND DEVELOPMENT REVIEW COMMITTEE
(EDRC) REVIEW OF NEW ZEALAND

REF: EDR(77)17

1. SUMMARY: IN REFDOC CIRCULATED FOR JUNE 20 EDRC
REVIEW OF NEW ZEALAND, SECRETARIAT PAINTS SOMEWHAT
DEPRESSING PICTURE OF NEW ZEALAND ECONOMIC DEVELOPMENTS
IN 1976, A YEAR WHICH WITNESSED DECLINE IN GDP, CONTINU-
ING (ALBEIT DECELERATING) INFLATION, AND ONLY MODEST
IMPROVEMENT IN CURRENT ACCOUNT POSITION. MOREOVER,
SECRETARIAT INDICATES THAT RECENT TRENDS AND SHORT-TERM
PROSPECTS AUGER ILL FOR SIGNIFICANT IMPROVEMENT IN
ECONOMIC SITUATION DURING BALANCE OF 1977. (SECRETARIAT
DOES NOT GIVE FORECASTS FOR 1978.) IN ANALYZING CURRENT
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RECESSION, SECRETARIAT ASSIGNS IMPORTANT ROLE TO RESTRIC-
TIVE FISCAL POLICY IN GENERATING DECLINE IN REAL GDP
GROWTH LAST YEAR, AND COMMENTS THAT FISCAL POLICY IS
LIKELY TO REMAIN TIGHT IN 1977. SECRETARIAT COMMENTS
THAT PRESENT CURRENT ACCOUNT DEFICIT IS UNSUSTAINABLE,
AND PRESENTS ANALYSIS OF CURRENT ACCOUNT ADJUSTMENT PROB-
LEM OVER MEDIUM TERM. SECRETARIAT CONCLUDES THAT GNZ

SHOULD EMPHASIZE POLICIES WHICH WOULD INCREASE RELATIVE PROFITABILITY OF EXPORT SECTOR (ESPECIALLY AGRICULTURE) RATHER THAN RELYING EXCLUSIVELY ON DEMAND RESTRAINT TO REDUCE CURRENT ACCOUNT DEFICIT TO SUSTAINABLE PROPORTIONS FOR SHORT RUN, SECRETARIAT RECOMMENDS CONTINUATION (BUT NOT INTENSIFICATION) OF FISCAL RESTRICTION, IMPROVEMENT IN EFFICIENCY OF MONETARY POLICY, AND REINFORCEMENT OF PROGRAMS FOR STABILIZATION OF EXPORT EARNINGS. ACTION REQUESTED: MISSION WOULD APPRECIATE COMMENTS/QUESTIONS WHICH COULD USEFULLY BE POSED AT REVIEW. FOR WELLINGTON: MISSION WOULD WELCOME EMBASSY'S COMMENTS ON SECRETARIAT'S ANALYSIS AND RECOMMENDATION. END SUMMARY

2. SHORT-TERM PROSPECTS; DOMESTIC OUTLOOK: SECRETARIAT NOTES THAT 1976 WAS A BAD YEAR FOR THE NEW ZEALAND ECONOMY. REAL GDP DECLINE OF 1/2 PERCENT WAS INDUCED BY DROP IN NEARLY ALL COMPONENTS OF DOMESTIC DEMAND. PRIVATE INVESTMENT SPENDING FELL BY 3 PERCENT AND CONTRIBUTED, TOGETHER WITH SHARP DECLINE IN PUBLIC INVESTMENT, TO 9 PERCENT DECREASE IN GROSS FIXED CAPITAL FORMATION. DESPITE WEAKNESS OF DOMESTIC DEMAND, CONSUMER PRICES INCREASED BY 17 PERCENT (ALTHOUGH DECELERATING DURING YEAR) AND UNEMPLOYMENT CONTINUED TO RISE.

3. OUTLOOK FOR 1977: SECRETARIAT EXPECTS ONLY MODEST IMPROVEMENT IN NZ ECONOMIC PERFORMANCE IN 1977. SECRETARIAT FORECASTS SLOW GROWTH (1 PERCENT) OF REAL DISPOSABLE INCOME THIS YEAR AND EQUIVALENT RISE IN PRIVATE LIMITED OFFICIAL USE

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CONSUMPTION DUE TO LIKELY STABILITY OF SAVINGS RATIO. GROSS FIXED CAPITAL FORMATION SHOULD DECLINE BY 5 PERCENT, ALTHOUGH TREND OF PRIVATE INVESTMENT COULD SHOW SOME ACCELERATION DURING THE YEAR. SECRETARIAT PROJECTS 1 PERCENT FALL IN DOMESTIC DEMAND THIS YEAR, SMALL POSITIVE CONTRIBUTION TO GROWTH FROM REAL FOREIGN BALANCE, AND 1/2 PERCENT FALL IN REAL GDP. LABOR MARKET SHOULD CONTINUE TO BE WEAK, BUT CONSUMER PRICES COULD RISE SOMEWHAT LESS RAPIDLY (13 PERCENT) THAN IN 1976.

4. SECRETARIAT PRESENTS DETAILED ANALYSIS OF CURRENT RECESSION AND CONCLUDES THAT (A) DECLINE IN REAL NATIONAL INCOME HAS BEEN EXCEPTIONALLY SHARP BY OECD AREA STANDARDS; (B) WAGE EARNERS HAVE IMPROVED THEIR POSITION RELATIVE TO OTHER GROUPS AND (C) WHILE RECESSION WAS "IMPORTED" TO LARGE EXTENT, IT HAS BEEN PROLONGED (I.E., SINCE MID-1975) BY RESTRICTIVE FISCAL POLICY.

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5. CURRENT ACCOUNT: NZ RECORDED CURRENT ACCOUNT DEFICIT OF NZ\$950 MILLION IN 1976, COMPARED TO DEFICIT OF NZ\$750 MILLION FORECAST BY SECRETARIAT. (NOTE: U.S. DOLLAR AND NZ DOLLAR ARE PRESENTLY CLOSE TO PARITY.) FOR 1977, SECRETARIAT FORECASTS 11.5 PERCENT (OR SOMEWHAT LESS) INCREASE IN EXPORT VOLUMES, 3 PERCENT DECLINE IN IMPORT VOLUMES AND IMPROVEMENT IN TERMS OF TRADE. HOWEVER, IN SECRETARIAT VIEW, PROBABLE SHRINKAGE OF TRADE DEFICIT WILL BE OFFSET BY INCREASED NET OUTFLOW OF INVESTMENT INCOME AND HIGHER DEBT SERVICE PAYMENTS, WITH RESULT THAT CURRENT ACCOUNT DEFICIT IS FORECAST TO RISE TO NZ\$1.0 BILLION. SECRETARIAT COMMENTS THAT CURRENT ACCOUNT DEFICIT OF PRESENT MAGNITUDE (8 PERCENT OF GDP) IS UNSUSTAINABLE OVER MEDIUM TERM, BUT DOES NOT FEEL THAT NZ WILL EXPERIENCE EXTERNAL FINANCING DIFFICULTY IN SHORT RUN.

6. SECRETARIAT EMPHASIZES NEED FOR NZ TO REDUCE CURRENT
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ACCOUNT DEFICIT OVER MEDIUM TERM, PRESENTS ALTERNATIVE
ADJUSTMENT "SCENARIOS" AND DRAWS FOLLOWING CONCLUSIONS:

(A) COST OF REDRESSING CURRENT ACCOUNT POSITION WOULD
BE EXCESSIVE IF GNZ WERE TO RELY EXCLUSIVELY ON DEMAND
DEFLATION TO DO THE JOB (ON ASSUMPTION THAT TERMS OF
TRADE WILL IMPROVE BY 2 PERCENT PER ANNUM, SECRETARIAT
INDICATES THAT A GDP GROWTH RATE OF 1 PERCENT PER ANNUM
WOULD BRING ABOUT CURRENT ACCOUNT BALANCE ONLY IN 1984);
(B) THUS, GNZ SHOULD FOCUS ON "EXPENDITURE SWITCHING"
(E.G., THROUGH IMPROVING PROFITABILITY OF EXPORT SECTOR
THROUGH EXCHANGE RATE DEPRECIATION, TAX INCENTIVES, ETC.)
RATHER THAN "EXPENDITURE REDUCTION" TO ACHIEVE NECESSARY
CURRENT ACCOUNT ADJUSTMENT; (C) EXISTENCE OF AGRICULTURAL
PROTECTIONISM ABROAD WILL HAMPER GNZ'S EFFORTS TO IMPROVE
CURRENT ACCOUNT.

7. FISCAL AND MONETARY POLICY: AS NOTED IN PARA 1

ABOVE, SECRETARIAT FEELS THAT RESTRICTIVE FISCAL POLICY
HAS HELPED PROLONG NZ RECESSION. MONETARY POLICY, HOW-

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CURRENT ACCOUNT.

7. FISCAL AND MONETARY POLICY: AS NOTED IN PARA 1 ABOVE, SECRETARIAT FEELS THAT RESTRICTIVE FISCAL POLICY HAS HELPED PROLONG NZ RECESSION. MONETARY POLICY, HOWEVER, HAS BEEN ACCOMMODATING. SECRETARIAT NOTES THAT FISCAL POLICY IS LIKELY TO REMAIN RESTRICTIVE THROUGHOUT 1977. ROLE OF MONETARY POLICY MORE UNCERTAIN DUE TO INSTITUTIONAL CONSTRAINTS ON ITS EFFECTIVE OPERATION.

8. MAIN CONCLUSIONS: BASED ON ANALYSIS IN REFDOC, SECRETARIAT SUGGESTS THAT EDRC COME TO FOLLOWING MAIN CONCLUSIONS:

(A) GIVEN CURRENT ACCOUNT CONSTRAINTS, RESTRICTIVE FISCAL POLICY SHOULD BE MAINTAINED, BUT NOT INTENSIFIED, IN 1977;

(B) TO ENHANCE EFFECTIVENESS OF MONETARY POLICY, REFORMS IMPLEMENTED IN MARCH OF 1976 SHOULD BE CARRIED FURTHER;

8. MAIN CONCLUSIONS: BASED ON ANALYSIS IN REFDOC, SECRETARIAT SUGGESTS THAT EDRC COME TO FOLLOWING MAIN CONCLUSIONS:

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(B) TO ENHANCE EFFECTIVENESS OF MONETARY POLICY, REFORMS IMPLEMENTED IN MARCH OF 1976 SHOULD BE CARRIED FURTHER;

(C) REDUCTION OF CURRENT ACCOUNT DEFICIT OVER MEDIUM TERM IS ESSENTIAL. GNZ POLICIES SHOULD AIM TO INDUCE SHIFT OF RESOURCES INTO EXPORT SECTOR BY ENHANCING RELATIVE PROFITABILITY OF EXPORT PRODUCTION, RATHER THAN TO ACHIEVE THIS RESULT THROUGH DEMAND DEFLATION ALONE.

9. COMMENT: (A) IN ITS ANALYSIS OF THE CURRENT RECESSION, SECRETARIAT STATES THAT RESTRICTIVE FISCAL POLICY

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IMPORTANTLY TO RECESSION'S DEPTH AND DURATION. IN MISSION VIEW, SECRETARIAT PLACES UNDUE EMPHASIS ON ROLE OF FISCAL POLICY IN THIS RESPECT, WHILE UNDERPLAYING DEFLATIONARY IMPACT OF DRAMATIC DETERIORATION IN NZ TERMS OF TRADE. SECRETARIAT ITSELF INDICATES THAT NZ ECONOMY STARTED DOWNWARD IN MID-1973, BUT THAT FISCAL POLICY DID NOT TURN RESTRICTIVE UNTIL MID-1975 (GIVEN LAGS INVOLVED, IMPACT OF RESTRICTIVE SHIFT MIGHT NOT HAVE BEEN FELT UNTIL 1976). FURTHERMORE, SECRETARIAT NOTES THAT CHANCES OF RETURN TO SUSTAINABLE CURRENT ACCOUNT POSITION IN FORESEEABLE FUTURE WOULD HAVE BEEN GREATLY REDUCED HAD FISCAL POLICY NOT SHIFTED IN 1975. "TONE" OF REFDOC GIVES IMPRESSION THAT SECRETARIAT IS "BLAMING" GNZ FISCAL POLICY FOR RATHER SAD CURRENT STATE OF THE ECONOMY. MISSION WOULD MAKE ABOVE POINTS AND SOLICIT NZ DEL'S COMMENTS;

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(B) IN ITS ANALYSIS OF CURRENT ACCOUNT ADJUSTMENT PROBLEMS AND POLICIES, SECRETARIAT NOTES THAT SOME OF ITS ASSUMPTIONS CONCERNING DEVELOPMENTS IN EXTERNAL ENVIRON-

MENT ARE OPTIMISTIC. IN CONCLUSIONS SECTION OF REFDOC, SECRETARIAT INDICATES THAT IF ITS ASSUMPTIONS TURN OUT TO BE TOO OPTIMISTIC, NZ WILL BE FACED WITH "EXTREMELY SERIOUS PROBLEMS." MISSION WOULD ASK SECRETARIAT AND NZ TO COMMENT ON THIS POINT IN PARTICULAR AND ON SECRETARIAT'S MEDIUM-TERM SCENARIO IN GENERAL;

(C) SECRETARIAT SUGGESTS THAT TO REDRESS CURRENT ACCOUNT POSITION, GNZ SHOULD EMPHASIZE POLICIES TO INDUCE "EXPENDITURE SWITCHING" AS OPPOSED TO "EXPENDITURE REDUCTION." MISSION WOULD NOTE THAT THESE POLICIES SHOULD BE VIEWED MORE AS COMPLEMENTS RATHER THAN AS ALTERNATIVES. NONETHELESS, MISSION WOULD SUPPORT SECRETARIAT VIEW THAT MORE FLEXIBLE EXCHANGE RATE POLICY COULD ASSIST ADJUSTMENT PROCESS OVER MEDIUM TERM.

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